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SUBJECT: UKRAINE: 2009 INTERNATIONAL NARCOTICS CONTROL STRATEGY REPORT

¶1. (U) Corruption, organized crime, prostitution, smuggling, tax evasion, and trafficking in persons, drugs and arms continue to be sources of laundered funds in Ukraine. As of November 1, 2009, Ukraine has 185 licensed banks, five of which are state-owned. There are no offshore financial centers or facilities under Ukraine's jurisdiction.

¶2. (U) In January 2001, the Government of Ukraine (GOU) enacted the "Act on Banks and Banking Activities," which introduced some anti-money laundering (AML) requirements for banking institutions. The Act prohibits banks from opening accounts for anonymous persons, requires the reporting of large transactions and suspicious transactions to state authorities, and provides for the lifting of bank secrecy pursuant to an order of a court, prosecutor, or specific state body. In August 2001, the President signed the "Law on Financial Services and State Regulation of the Market of Financial Services." This law establishes regulatory control over nonbank financial institutions that manage insurance, pension accounts, financial loans, or "any other financial services involving savings and money from individuals." The law provides definitions for "financial institutions" and "services," imposes record keeping requirements on obligated entities, and identifies the responsibilities of regulatory agencies. The law establishes the State Commission on Regulation of Financial Services Markets (SCFM), which, along with the National Bank of Ukraine (NBU) and the State Commission on Securities and the Stock Exchange, has responsibility for regulating financial services markets.

¶3. (U) Ukraine's AML and anti-financing of terrorism (AFT) regime has long been the subject of international scrutiny and criticism. The Financial Action Task Force (FATF) placed Ukraine on the list of non-cooperating countries and territories (NCCT) in September 2001. Following substantial Ukrainian efforts to adopt appropriate legislation and institute an enforcement regime, FATF removed Ukraine from all monitoring in 2006. Since that time, however, Ukraine has remained subject to review by the Council of Europe's Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL), a FATF-style regional body (FSRB).

¶4. (U) In March 2009, MONEYVAL issued a Mutual Evaluation Report, based on its Round III Evaluation of Ukraine's AML and AFT regime. That Report was not favorable. It scrutinized Ukraine's level of compliance as to each of the forty plus nine FATF recommendations, and found partial or no compliance as to 33 of them. Also in 2009, FATF's International Cooperation and Review Group (ICRG) included Ukraine among 39 countries worldwide, and 12 countries in Europe, whose AML and AFT regimes would be subjected to "prima facie" review by the ICRG. In October 2009, the ICRG concluded that, because of continuing deficiencies, Ukraine would be one of 25 countries whose AML and AFT regimes would be subjected to additional "targeted review" by the ICRG. That targeted review is expected to continue at least through the spring of 2010, and should provide substantial

impetus toward continued improvement.

¶5. (U) The Criminal Code of Ukraine has separate provisions criminalizing drug-related and nondrug-related money laundering. Amendments to the Code adopted in January 2003 include willful blindness provisions and expand the scope of predicate crimes for money laundering to include any action punishable under the Criminal Code with imprisonment of three years or more, excluding certain specified actions. Amendments added in 2008 criminalized insider trading, although the text of those amendments still needs improvement. Additional draft amendments to the Criminal Code and Criminal Procedure Codes remain under review in Parliament.

¶6. (U) In November 2002, Ukraine enacted an AML package entitled "On Prevention and Counteraction of the Legalization (Laundering) of the Proceeds of Crime" (the Basic AML Law). The Basic AML Law establishes a two-tier system of financial monitoring, consisting of initial financial monitoring (i.e., obligated entities that carry out financial transactions) and state financial monitoring (i.e., government agencies charged with regulation and supervision of the financial institutions). Overall regulatory authority is vested in the SCFM.

¶7. (U) To correct deficiencies in the Basic AML Law, legislation enacted in February 2003 requires banks and other financial service providers to implement AML compliance programs, conduct due diligence to identify beneficial account owners prior to opening an account or conducting certain transactions, report suspicious transactions to the SCFM and maintain records on suspicious transactions and the people carrying them out for a period of five years. The legislation includes a "safe harbor" provision that protects reporting institutions from liability for cooperating with

law enforcement agencies. In August 2003 the SCFM established the State Register of financial institutions, and by January 2009 the State Register contained information on 2,016 nonbank financial institutions.

¶8. (U) On November 6, 2009, Parliament passed significant amendments to the Basic AML law, aimed at bringing Ukraine's regime into compliance with FATF's revised Forty plus Nine recommendations. However, the President vetoed the bill on December 8 in response to pressure from the financial community, which complained of onerous additional reporting requirements. The veto is a disappointment, as the passage of these amendments would have represented a significant step forward for Ukraine, particularly since different forms of the legislation had been pending in Parliament since 2003. It is possible that the Parliament will override the veto before the end of 2009; alternatively, the amendments may be reintroduced in the Parliament some time after Ukraine's January Presidential elections.

¶9. (U) The main thrust of the new amendments was to broaden substantially the types of entities and professionals that are subject to financial monitoring, adding lawyers and law firms, real estate firms, auditors, notaries, traders in precious metals, post offices (for money transfers), lottery companies, consulting companies and other professionals. An additional important innovation in the vetoed law was that it provided that Politically Exposed Persons (PEPs) would be subject to financial monitoring, and that PEPs include not only foreign but also Ukrainian officials. PEPs would include the president, prime minister, ministers, members of Parliament, public officials, law enforcement officials and others. There were also new mechanisms empowering the FIU to temporarily suspend suspicious transactions that appear potentially tied to money laundering.

¶10. (U) In sum, the law would take some significant steps toward bringing Ukraine's AML and AFT regime into compliance with the FATF forty plus nine recommendations. However, substantial deficiencies would still remain in Ukraine's regime. Some such deficiencies are legislative such as gaps in laws pertaining to asset forfeiture, corporate criminal liability and insider trading. Other deficiencies include the continued failure of the Prosecutor General's Office (PGO) and the investigative agencies to cooperate effectively, thus

undermining the effective use of criminal prosecutions.

¶11. (U) In 2004, authorities reduced the monetary threshold for compulsory financial monitoring from Ukrainian hryvnias (UAH) 300,000 (approximately $40,000) for cashless payments and UAH 100,000 (approximately $13,333) for cash payments, to UAH 80,000 (approximately $10,666) for payments using either method. The compulsory reporting threshold exists only if the transaction also meets one or more suspicious activity indicators as set forth by law. Any transaction suspected of being connected to AFT must be reported to appropriate authorities immediately.

¶12. (U) Beginning in May 2008, as a result of amendments to the "Resolution on the Adoption of Instructions Regarding Movement of Currency, Precious Metals, Payment Documents, and Other Banking Documents over the Customs Border of Ukraine," travelers must declare cross-border transportation of cash sums exceeding Euro 10,000, and name the origin of such funds. Cash smuggling is substantial in Ukraine, although it is reportedly more related to unauthorized capital flight than to criminal proceeds or terrorist funding.

¶13. (U) In 2005, the GOU sought to combat smuggling and corruption by reducing import duties, introducing new procedures for the Customs Service, and implementing transparent procedures for the privatization of state enterprises. Ukraine's 2005 budget eliminated the tax and customs duty privileges available in 11 Special Economic Zones (SEZs) and nine Priority Development Territories (PDTs) that operated within Ukraine, which had been associated with rampant evasion of customs duties and taxes. Several draft laws have been registered with Parliament to restore the tax and customs privileges in the SEZs; however, none of them was given serious consideration.

¶14. (U) Under a January 2006 amendment (Law 3163-V) to Ukraine's AML laws, the entities obligated to conduct initial financial monitoring must be able to provide proof they are fulfilling all Know Your Customer (KYC) identification requirements. The law also grants state agencies enhanced authority to exchange information internationally, improves rules on bank organization, and implements a screening requirement at the level of financial institutions. On September 14, 2006, Ukraine enacted amendments to the "Law on Banks and Banking" that require all banks to be formed as open joint-stock companies or as cooperatives. This measure strengthens disclosure

requirements on the identity of the beneficial owners of banks. These amendments apply to all newly formed banks and provide a three-year period for existing banks to comply. 173 of Ukraine's 185 licensed banks are joint stock companies.

¶15. (U) The SCFM, Ukraine's FIU, was established in December 2001 by the Presidential Decree "Concerning the Establishment of a Financial Monitoring Department." The SCFM became operational in June 2003. At that time, the SCFM was an independent authority administratively subordinate to the Ministry of Finance and the sole agency authorized to receive and analyze financial information from financial institutions. Effective January 1, 2005, Ukraine's Parliament granted the SCFM the status of a central executive agency, subordinate to the Cabinet of Ministers rather than to the Ministry of Finance. The Basic AML Law specifically states the SCFM is to operate free from political influences. The director of the SCFM was replaced in February 2008, shortly after a new government came to power, but observers in Ukraine did not conclude that step was primarily politically motivated.

¶16. (U) As of December 1, 2009, the SCFM has 22 local branches in Ukraine's regions. The SCFM is an administrative agency with no investigative or arrest authority. It is authorized to collect suspicious transaction reports (STRs) and analyze suspicious transactions, including those related to terrorist financing, and to transfer financial intelligence information to competent law enforcement authorities for investigation. The SCFM identifies possible cases for investigation by the Ministry of Interior, Tax Agency, State Security Agency and PGO. The SCFM processes, analyzes, and develops cases reportedly to the point of establishing the equivalent of probable cause prior to referral to law enforcement.

The SCFM also has the authority to approve interagency agreements and exchange intelligence on financial transactions involving money laundering or terrorist financing with other FIUs. As of December 2009, the SCFM has signed memoranda of understanding (MOUs) with the FIUs of 46 countries. It has become a regional leader with regard to the volume of case information exchanged with counterpart FIUs. In July, 2009, Ukraine amended the law on Banks and Banking to permit international exchange of information between the National Bank and respective regulators of other countries for purposes of combating money laundering.

¶17. (U) In 2008, the SCFM received 1,083,461 transaction reports, which include STRs and automatic threshold reports. Ninety-seven percent of the transaction reports were submitted by banks, and all came in an electronic format. The SCFM designated approximately 14 percent of these for "active research" and sent 641 separate cases to law enforcement agencies. Of these cases, the SCFM referred 30 to the PGO, 207 to the State Tax Administration, 175 to the Ministry for Internal Affairs, and 229 to the State Security Service of Ukraine. The volume of funds implicated in the cases is UAH 28.8 billion (USD 3.7 billion). As a result of subsequent investigation of these cases, law enforcement agencies initiated 354 formal criminal investigations, and submitted indictments in 117 of those cases (the number tripled over 2007). Between 2003 and 2008, 950 formal criminal investigations were opened, and indictments submitted in 176 of these cases. Convictions have been obtained in 104 of these cases. Although the reporting system is effective and the SCFM has generated a substantial number of cases, it did not lead to a significant number of convictions until 2007. From 2003-2006 there were convictions in only three cases, while in 2007, the number of convictions jumped to 25, followed by 76 convictions in 2008.

¶18. (U) Many observers believe the low prosecution and conviction rates are caused by reluctance at the PGO to follow up on the cases referred by the SCFM and by a lack of prosecutorial specialization. Local prosecutors may close money laundering investigations and cases prematurely or arbitrarily, possibly because of lack of sufficient manpower or resources, corruption, a weak understanding of money laundering crimes, or a belief that other types of crimes should take priority over money laundering.

¶19. (U) Ukraine has been working with the European Commission and Council of Europe to increase its capacity to fight money laundering and terrorist financing since 2003. A long-term Council of Europe project, which ran through April 2009, focused on three areas: getting Ukraine's legislative framework up to international standards; enhancing the human capacities of key institutions and agencies; and developing the organizational and technical infrastructure of the system.

¶20. (U) Ukraine has a general asset forfeiture regime, but this is largely an inappropriate and ineffective relic of Soviet-era legislation. Article 59 of the Ukrainian Criminal Code provides for

the mandatory seizure of all or a part of the property of any person convicted for grave or particularly grave offenses, as defined in the code, regardless of whether this property bore any relation to the crime of conviction. With respect to money laundering, Article 209 allows for the forfeiture of criminally obtained money and other property. However, Ukraine lacks any functional regime for locating or seizing forfeitable assets. In particular, Ukraine lacks legislation allowing in ram forfeiture or the seizure of corporate assets, has no specialized asset forfeiture prosecutors or officials, and lacks any entity to administer forfeited assets. The GOU has drafted legislation aimed at improving the asset forfeiture regime and bringing it into compliance with international standards. That legislation was submitted to Parliament in January 2009 but has not yet been acted upon.

¶21. (U) In December 2003, the Cabinet of Ministers issued Decree No. 1896, establishing a Unified State Information System of Prevention and Counteraction of Money Laundering and Terrorism Financing. The system provides the SCFM with unobstructed access to the databases of 12 ministries and agencies, including the Ministry of Internal

Affairs, Ministry of Economy, Ministry of Finance, State Tax Administration, State Security Service, State Customs Administration, State Property Fund, State Statistics Administration, Border Guard Service, Securities Commission, Financial Services Commission, and Control and Revision Department. The system became fully operational in December 2006. The SCFM leadership states it has unfettered access to all relevant information in the data bases of the aforementioned agencies.

¶22. (U) The SCFM acknowledges the existence and use of alternative remittance systems in Ukraine, and SCFM personnel have attended seminars and exchanged information about such systems. In 2007, the Security Service of Ukraine published a report signaling that hawala might be on the rise in Ukraine due to a large number of Ukrainians working abroad and the growth of foreign communities in Ukraine. The SCFM and security agencies monitor charitable organizations and other nonprofit entities that might be used to finance terrorism.

¶23. (U) Law 3163-IV, which entered into force on January 1, 2006, enhances Ukraine's ability to exchange information internationally and places greater obligations on banks to combat terrorist financing. This law requires banks to adopt procedures to screen parties to all transactions using a SCFM-issued list of beneficiaries of, or parties to, terrorist financing. Banks must freeze assets for two days and immediately inform the FIU and law enforcement bodies whenever a party to a transaction appears on the list. The FIU can extend the freeze to five days. Banks developed their screening capabilities subsequent to implementation of the law. In October 2006, the Cabinet of Ministers approved the SCFM's list, drawn from three sources: the United Nations 1267 Sanctions Committee's consolidated list; information from the Ukrainian Security Service on individuals and entities suspected of violating article 258 of the Ukrainian Criminal Code concerning terrorism; and the lists compiled by those countries that have bilateral agreements with Ukraine on mutual recognition of terrorist designations. In September 2006, Parliament enacted revisions to Article 258 of the Criminal Code, adding Article 258-4 which explicitly criminalizes terrorist financing. The revised text mandates imprisonment from three to eight years for financing, material provision, or provision of arms with the aim of supporting terrorism. The revisions also amend the criminal procedure code to empower the State Security Service (U) with primary responsibility for investigating terrorist financing.

¶24. (U) The GOU has cooperated with U.S. efforts to track and freeze the financial assets of terrorists and terrorist organizations. The NBU, the SCFM, the Securities Exchange Commission, the State Tax Administration, the U, and the Ministries of Finance, Internal Affairs, and Foreign Affairs are informed about the U.S. designation of suspected terrorists and terrorist organizations under Executive Order 13224 and other U.S. authorities. Through their regulatory agencies, banks and nonbank financial services also receive these U.S. designations and are instructed to report any transactions involving designated individuals or entities.

¶25. (U) The U.S.-Ukraine Treaty on Mutual Legal Assistance in Criminal Matters was signed in 1998 and entered into force in February 2001. A bilateral Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, which provides for the exchange of information in administrative, civil, and criminal matters, is also in force.

¶26. (U) Ukraine is a party to the 1988 UN Drug Convention, the UN Convention for the Suppression of the Financing of Terrorism, and

the UN Convention against Transnational Organized Crime. Ukraine has signed, but not yet ratified, the UN Convention against Corruption. Ukraine is a member of MONEYVAL and also an observer and technical assistance donor to the Eurasian Group on Combating Money Laundering and the Financing of Terrorism (EAG), another FSRB. The SCFM is a member of the Egmont Group. It hosted working level meetings of the Egmont Group in Ukraine in October 2007.

¶27. (U) Over the years, Ukraine has strengthened and clarified its

legislation and, with the SCFM, the NBU, and other actors in the financial and legal sectors, the GOU has also established a comprehensive AML monitoring regime. However, Ukraine's ability to implement this regime through consistent successful criminal prosecutions has yet to be proven. Ukraine should adopt draft legislation to bring its AML/AFT regime into closer accordance with both the language and the intent of FATF and international standards. The recent veto of amendments that would do just this is unfortunate, but still may be overcome in the near future. The GOU also should consider carefully the consequences of reestablishing tax and customs privileges that have been abused in the past. The GOU should also take steps to improve implementation of its AML/AFT regime. The PGO should address the deficiencies of that office, such as a lack of specialization and limited professional experience with money laundering. Law enforcement agencies should give higher priority to investigating and prosecuting money laundering cases. Both law enforcement officers and the judiciary need a better understanding of the theoretical and practical aspects of investigating and prosecuting money laundering cases. Ukraine also should ratify the UN Convention against Corruption, and more aggressively address public corruption by investigating, prosecuting and convicting corrupt public officials.
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